FILE COPY

IN THE

Supreme Court of the United States

OCTOBER TERM, 1947

No. 451

ANDREW W. COMSTOCK, a holder of Missouri Pacific Railroad Company 5¼% Secured Serial Gold Bonds, on behalf of himself and others holding upward of $900,000 principal amount of said bonds,

Petitioner,

vs.

GROUP OF INSTITUTIONAL INVESTORS, holding First and Refunding Mortgage 5% Gold Bonds of Missouri Pacific Railroad Company, et al.,

Respondents.

PETITIONER'S BRIEF

WILLIAM H. BIGGS,
Attorney for Petitioner,
Security Building,
St. Louis 2, Missouri.

PHILLIP I. BLUMBERG,
of Counsel.

INDEX

TABLE OF CASES

TABLE OF STATUTES AND OTHER AUTHORITIES

Table of Abbreviations

MOP: Missouri Pacific R. R., the parent corporation asserting the Intercompany Claim in the case at bar.

Alleghany: Alleghany Corporation, owner of a majority stock interest in Missouri Pacific Railroad. It acquired control of MOP in 1930.

NOTM: New Orleans, Texas & Mexico Ry., a controlled and dominated subsidiary of MOP and the company against which MOP is asserting its Claim. MOP acquired control of NOTM in 1924.

Brownsville: St. Louis, Brownsville & Mexico Ry., the principal subsidiary of NOTM.

Beaumont: Beaumont, Sour Lake & Western Ry., another subsidiary of NOTM.

IGN: International-Great Northern Ry., a North Texas railroad regarded as a subsidiary of MOP, although stock owned by NOTM; not deemed a part of the Gulf Coast Lines.

GCL: Gulf Coast Lines, the railroad system in South Texas and Louisiana composed of NOTM and its subsidiaries, excluding IGN.

Commission: Interstate Commerce Commission.

SEC: Securities and Exchange Commission.

RFC: Reconstruction Finance Corporation.

RCC: Railroad Credit Corporation.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1947

No. 451

ANDREW W. COMSTOCK, a holder of Missouri Pacific Railroad Company 5¼% Secured Serial Gold Bonds, on behalf of himself and others holding upward of $900,000 principal amount of said bonds,

Petitioner,

vs.

GROUP OF INSTITUTIONAL INVESTORS, holding First and Refunding Mortgage 5% Gold Bonds of Missouri Pacific Railroad Company, et al.,

Respondents.

PETITIONER'S BRIEF

Jurisdiction

Jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended. Petition for writ of certiorari to the Circuit Court of Appeals for the Eighth Circuit was granted on January 12, 1948.

The Opinions of the Courts Below

The opinion of the District Court (R. 1089 *) is reported in 64 F. Supp. 64. The opinion of the Circuit Court

---

* References to the transcript of the record are indicated by the letter "R", except for Volume IV thereof, which is indicated by "R. IV". References to the volumes of exhibits are indicated by the letters "Ex.". Arabic numerals in all instances indicate pages.

The record consists of four volumes of transcript and two volumes of exhibits.

of Appeals for the Eighth Circuit (R. IV-13) is reported in 163 F. (2d) 350.

Preliminary Statement

This case involves the validity and priority of a claim of $10,565,227 filed by the Missouri Pacific R. R. Co. (hereinafter called MOP) against its controlled and dominated subsidiary, New Orleans, Texas & Mexico Ry. Co. (hereinafter called NOTM) in joint reorganization proceedings under Section 77 of the National Bankruptcy Act, as amended.

This brief is submitted by petitioner, Andrew W. Comstock, representing himself and fourteen other public investors holding in excess of $980,000 principal amount of MOP 5¼% Secured Serial Gold Bonds.*

This class of MOP bonds is secured by MOP's pledge of 82% of the outstanding shares of NOTM's sole class of stock (Ex. 304, R. 917).

MOP seeks to insert its claim against NOTM ahead of the claims of public investors secured by such pledge.

Petitioner contends that the MOP Intercompany Claim must be disallowed, or, to the extent, if any, not disallowed, subordinated to the claim of all public investors, holding MOP 5¼% Secured Bonds.

---

* Andrew W. Comstock is the holder of $80,000 principal amount of such bonds. The names and holdings of the fourteen other public investors holding in excess of $900,000 additional principal amount of such bonds have previously been stated in these proceedings.

Comstock filed his objections relating to the MOP Intercompany Claim on behalf of himself, such fourteen other investors, and on behalf of all owners and holders of such bonds (R. 227). Comstock's objections were adopted by the Missouri Pacific R. R. Co. 5¼% Serial Bondholders Committee presently holding and representing at least an additional $315,000 principal amount of such bonds (*Interstate Commerce Commission Report*, October 15, 1947, pp. 2-3). This comprises an aggregate total of $1,295,000, or about 11½% of all such bonds publicly outstanding.

The Parties

Petitioner's interest arises out of the 82% of NOTM stock pledged as security for the MOP 5¼% Secured Bonds. The Commission has recognized that such stock is of value (R. 20835, 20955). If the MOP Claim is invalid or subordinated to the claim of such bonds, the value of the pledged NOTM stock will be greatly enhanced. Consequently, the allocation of new securities to MOP 5¼% Secured Bonds is dependent upon the judicial determination of the validity and priority of the MOP claim.

The leading respondent is the Group of Institutional Investors Holding First and Refunding Mortgage Bonds of MOP; this group represents 10% or less of such bonds. Sen. Rep. No. 432, 80th Cong., 1st Sess., pp. 22-23 (1947). This Group admitted that it had "no financial interest in the controversy revolving about" the MOP Claim, and that its interest was only to expedite a Plan of Reorganization of which it was then the leading proponent. This plan has since been returned to the Commission (Institutional Group Brief, Dist. Ct., p. 2). The Institutional Group offered the only evidence in the District Court in support of the MOP Claim.

Another respondent is the NOTM Mortgage and Income Bondholders Committee, which had similarly stated that it has "no interest" in the litigation over the Claim (R. 366).

Other respondents include MOP itself, MOP common and preferred stockholders committees, the Trustee of MOP, Alleghany Corporation, certain groups of creditors and indenture trustees.

Facts

There is remarkably little in the Record which is disputed. Almost all the evidence is documentary—taken from the books and records of MOP, NOTM and NOTM subsidiaries.

In these proceedings, MOP filed a proof of claim agains NOTM in the amount of $10,565,226.78, allegedly based o

> "cash advances for operation, interest payments, etc at various times from March, 1929, to February, 193 both inclusive" (Ex. 1, R. 402).

No steps were taken by MOP, the claimant, or on it behalf, to have such claim adjudicated or allowed. Mr Thompson—the sole trustee of MOP, of NOTM and o NOTM subsidiaries *—took no steps to oppose it.

Public investors found it necessary to assume the bur den of protecting NOTM against this claim. Petitione objected to the MOP Claim in the 1943 Interstate Commerc Commission (hereinafter called the Commission) hearing on the then pending MOP Plan. The Commission rule that the issue of the validity and priority of the MO Intercompany Claim "should be left to litigation in th courts" and that it would "assume for the purposes of thi proceeding that they (the MOP advances) are valid" (R 20842).**

Petitioner's objections relating to the MOP Claim were the subject of a separate court hearing and separat order (R. 736-737). The District Court overruled peti tioner's objections and held that the $10,565,227 clai "should be allowed" in full, together with interest at 5½% and 6%, presently aggregating in excess of $18,000,00

---

* Mr. L. W. Baldwin had originally been appointed a co-truste of these roads, but resigned in 1935 (R. 76, 89). The MOP proo of claim was filed by Mr. F. P. Johnson, Vice-President of MO and NOTM, not by the MOP Trustee.

** This Plan—at the request of the Commission—was returned t it in September, 1947. The Commission has set March 23, 1948 fo a hearing on proposed plans of reorganization.

† The petitioner's objections relating to the subordination of th securities owned by Alleghany Corporation were also set for a sep arate hearing. This hearing is still pending (R. 1102-1103).

The District Court further held that the claim, so allowed, was prior to the claims of public investors holding MOP 5¼% Secured Bonds (R. 7, 30-33). Petitioner appealed. The Circuit Court of Appeals for the Eighth Circuit affirmed (R. IV, 28).

MOP Ownership of NOTM, 1924 to Bankruptcy

Under circumstances condemned by the Commission, MOP acquired majority control of NOTM from a banking syndicate in 1924 (R. 9, 11; *Control of Gulf Coast Lines by Missouri Pacific R. R.*, 94 I. C. C. 191, 199-200, 204 (1924).

The price demanded for control of NOTM was more than MOP would pay. To facilitate the purchase, the agreement between MOP and the bankers required NOTM itself to pay part of the purchase price through extraordinary cash dividends to the old NOTM stockholders amounting to $2,475,000. These were in addition to the regular NOTM dividends of $1,010,000 for the year (Ex. 140-144, 197, R. 610, 664, 555-561).

The NOTM income and surplus in 1924 were insufficient to support such dividends (Ex. 197, R. 664). To provide NOTM with the necessary ostensible surplus, a liability of almost $3,000,000 was resurrected and imposed on NOTM's principal subsidiaries—the St. Louis, Brownsville & Mexico Ry. Co., and the Beaumont, Sour Lake & Western Ry. Co.* (hereinafter called Brownsville and Beaumont respectively) (Ex. 181-185, R. 636).

The payment of these resurrected obligations did not provide NOTM with sufficient funds to pay these dividends.

---

* This represented past due interest which NOTM in 1917 had "waived, cancelled and all things annulled so that neither of said companies shall hereafter be required to pay" (Ex. 180-181, R. 635).

NOTM was obliged to borrow large sums for this purpose * (R. 559-560).

To refinance its purchases of NOTM stock, MOP, in 1926, issued $13,156,000 of its 5¼% Secured Bonds to public investors. In accordance with the trust indenture under which the bonds were issued, 131,560 shares of NOTM stock were pledged by MOP as security for these bonds ** (R. 11-12).

MOP continued to acquire NOTM stock until it owned more than 93% upon bankruptcy (Ex. 177, R. 630).

From 1924 until bankruptcy, MOP dominated NOTM and NOTM subsidiaries through common officers and interlocking directorates (R. 11). MOP officers and directors immediately occupied a majority of the NOTM Board and offices. By 1929, every director and principal officer of NOTM was a MOP officer or director.

For example, until 1930, Mr. William H. Williams, Chairman of the Board of MOP with offices in New York, was Chairman of the Board of NOTM, IGN, Brownsville and Beaumont. In 1930, Mr. O. P. Van Sweringen, President of Alleghany Corporation, replaced Mr. Williams as head of all these companies and moved the Chairman's office to Terminal Tower, Cleveland, Ohio.

The other leading MOP officers such as President Baldwin, Vice-Presidents Johnson and Safford and Secretary-Treasurer Wyer all held similar positions in NOTM, IGN, Brownsville and Beaumont (Ex. 39-44, R. 405-406).

---

* Nevertheless, in NOTM's Annual Report for 1924 to the Commission, NOTM denied that it had borrowed to pay dividends (Ex. 197, R. 664).

** By bankruptcy, the amount of such bonds outstanding and of the stock pledged had been reduced to $12,140,000 and 121,460 shares respectively (Ex. 304, R. 917). Subsequently, the MOP Trustee, pursuant to Court order, purchased $895,000 of these bonds, leaving a total of $11,245,000, presently publicly outstanding (MOP Thirtieth Annual Report (1946), p. 11).

Early in 1929, Alleghany Corporation commenced large scale stock market operations in MOP securities, resulting in the acquisition of majority control of MOP by April, 1930. When Mr. O. P. Van Sweringen took Mr. Williams' place as Chairman of the Board of these five roads, seven of his associates replaced Mr. Williams' associates on the MOP and NOTM Boards (Sen. Rep. No. 714, 77th Cong., 1st Sess., Part 2, pp. 560-564 (1941); Ex. 26-61, R. 405-406, 869).

Throughout its period of control, MOP managed the financial affairs of NOTM for its own benefit. NOTM suffered from the lack of an independent management in the dividend policy imposed by MOP, in the shifting of indebtedness on the MOP books to NOTM, in the huge increase of NOTM indebtedness, in the failure to make provision for sound financing of the NOTM expansion program and in the acquisition with NOTM funds of North Texas "feeder" railroad lines for the benefit of MOP and IGN. All these financial transactions are reflected in the MOP Claim.

The Dividend Policy Imposed on NOTM

Under MOP control, NOTM was compelled to pay dividends in each and every quarter from 1925 through 1931, aggregating $7,267,000. Of these dividends, the sum of $6,473,000 went to MOP (Ex. 177, R. 630, 433). MOP caused NOTM to pay these dividends although NOTM was without funds and already borrowing for an extensive expansion and improvement program.

(a) NOTM Dividends to MOP Exceeded NOTM Earnings

NOTM dividends substantially exceeded income. In only two * of the seven years from 1925 through 1931 was NOTM's income adequate to pay the annual dividends exacted by MOP (Ex. 195, R. 663). This is considering NOTM as a separate corporate entity.

The consolidated earnings of NOTM and its Gulf Coast Lines subsidiaries were even less favorable. Total consolidated earnings were less than NOTM dividends in each year from 1927 to bankruptcy. During this period, NOTM paid twenty dividends totalling $5,190,000 against consolidated earnings of $1,151,000 (Ex. 301, R. 914). Over the full seven-year period, NOTM dividends totalled $7,267,000 against consolidated earnings of $5,481,000 (Ex. 301, R. 914).

NOTM dividends were not merely in excess of income. Mr. Wyer—former Treasurer of MOP and NOTM and the principal witness in support of the MOP Claim **—admitted before the United States Senate Committee on Interstate Commerce that 1931 NOTM dividends were paid out of capital.†

---

* Without the unpaid paper dividends from Brownsville which the Commission later condemned and directed NOTM to write off insofar as then still unpaid, NOTM suffered a substantial loss in 1931 although the books show an ostensible profit for the year (Ex. 62-64, 195, R. 420-422, 663).

** The Institutional Group delayed the presentation of their case so that Mr. Wyer could testify (R. 734). Mr. Wyer remained in the court-room during the proceedings below, advising respondents (R. 458).

† *Hearings before Sub-Committee of Senate Committee on Interstate Commerce* pursuant to S. Res. 71, 75th Cong., 1st Sess., Part 12, p. 5296 (1938); (R. 296). Judicial notice may be taken of these official reports. *Arizona* v. *California*, 283 U. S. 423, 453-454 (1931).

(b) Matching of Simultaneous MOP Advances to NOTM and NOTM Dividends to MOP

From the fall of 1928 until bankruptcy—and largely as a result of previous large dividend payments to MOP—the cash position of NOTM was impaired. NOTM lacked funds for its expansion and improvement program and to meet its bond interest, principal and interest on equipment trust notes, and sinking fund obligations (Ex. 281, R. 900).

MOP, nevertheless, forced NOTM to continue regular dividends through the end of 1931.

Commencing in the fall of 1928, NOTM was able to pay such dividends only as a result of matching advances from MOP (Ex. 281, R. 900; Ex. 75-79, R. 453). These MOP advances were paper transactions. MOP advanced sums to NOTM with one hand and took them back almost simultaneously by way of dividends with the other. Most of these paper advances were accomplished by checks drawn by an officer of MOP and then endorsed by the same person acting as an officer of NOTM (Ex. 83, 239; R. 455, 791). These advances are now included in MOP's Claim.

One MOP directive on the same day credited NOTM with an "advance" from MOP and credited MOP with a matching dividend from NOTM. Mr. Wyer, Treasurer of MOP and NOTM, wrote under the MOP letterhead to J. P. Morgan & Co., a depository for both MOP and NOTM. In one paragraph, Mr. Wyer directed the Morgan firm to credit NOTM with an advance of $300,000 on November 29, 1930. In another paragraph, Mr. Wyer advised the Morgan firm to credit MOP on that date with an NOTM dividend in the amount of $243,360 (Ex. 84, R. 456). MOP was thus credited with dividends from NOTM two days before December 1, 1930, the date set for payment (Ex. 281, R. 900).

Without such paper advances, NOTM could not have paid dividends (Ex. 75-79, R. 453). For example, on February 28, 1930, the NOTM Treasurer's account had a cash balance of only $13,565, although on the following day the

NOTM quarterly dividend of $259,576 was payable. On February 28 in New York City, Mr. O. B. Huntsman, as Assistant Secretary-Treasurer of MOP, issued a check for $260,000 to NOTM, and then as Assistant Secretary-Treasurer of NOTM endorsed it for deposit in the NOTM account. The NOTM quarterly dividend of $259,576 was paid on the next day with $242,072 going back to MOP (Ex. 75-83, 239, R. 453, 455, 791).

These are typical examples of the matching of advances from MOP to NOTM and dividends from NOTM to MOP. This matching was not an isolated transaction. It followed a consistent pattern. As the following chart shows, this matching was repeated in eleven out of thirteen consecutive quarters from November, 1928 until NOTM paid its last dividend in November, 1931 (Ex. 75-81, 177, 281, R. 19, 453, 630, 900).

	MOP "Advance" to NOTM	*NOTM Dividend to MOP*	*Date of MOP "Advance"*	*Dividend Followed "Advance"*
	$ 300,000	$ 233,231	Nov. 30, 1928	1 day later
	250,000	234,237	Feb. 28, 1929	1 " "
	275,000	239,429	Aug. 31, 1929	3 days "
	310,000	241,529	Nov. 29, 1929	2 " "
	260,000	242,072	Feb. 28, 1930	1 day "
	275,000	242,212	May 31, 1930	1 " "
	300,000	243,360	Nov. 29, 1930	Same day
	75,000	243,510	Feb. 25, 1931	3 days later
	200,000	244,387	May 27, 1931	5 " "
	250,000	244,527	Aug. 29, 1931	2 " "
	300,000	244,527	Nov. 27, 1931	4 " "
OTAL	$2,795,000	$2,654,000	$2,855,333	TOTAL DIVIDEND
VERAGE ADVANCE"	$ 254,091		$ 259,576	EACH NOTM DIVIDEND

Although MOP advanced to NOTM $2,795,000, it received back $2,654,000 in dividends within a few days. The total net advance from MOP to NOTM was only $141,000 ($2,795,000 less $2,654,000).

Yet the Courts below allowed MOP its claim of $2,795,000, plus interest of about $2,000,000,* aggregating about $4,795,000, for this net advance of $141,000. This constitutes a return of over 3400% to a fiduciary parent.

(c) Dividends Drained from Brownsville to Make Possible NOTM Dividends to MOP

Without the paper advances from MOP, payment of NOTM dividends would have been impossible. Without paper dividends drawn from NOTM's principal subsidiary, Brownsville, the ostensible legal basis for declaration of NOTM dividends would have been lacking.

The NOTM quarterly dividends were declared some weeks before the end of each quarter (Ex. 173, R. 617). Several weeks after the close of the quarter, NOTM earnings for the preceding quarter were ascertained. Such earnings were generally insufficient to cover the previously declared NOTM dividend. Consequently, MOP directed Brownsville to declare dividends expressly to cover the NOTM deficits resulting from such dividends.

On at least seventeen occasions from 1926 to 1931, following directives from Mr. Baldwin in St. Louis to Mr. Safford, in Houston, such Brownsville dividends were declared in amounts identical to the dollars and cents required to bring quarterly NOTM income up to the $259,575.75 dividend for such quarter previously paid by NOTM (Ex. 111-112, 123-134, 172, 206; R. 569-601, 616 674).

Brownsville could not make cash payment of its dividends at any time after 1926. Such paper dividends did

---

* All computations of interest in this Brief have been made at the rate of 5½% per annum from 1933 to 1946, the date of the District Court order.

not improve NOTM's cash position. Thus, NOTM from 1928 through 1931 was caused to borrow $2,795,000 for dividends and several additional millions for other purposes (Ex. 281, R. 900).

Dividends reached a climax in 1931. That was almost a catastrophic year for NOTM.

On April 14, 1931, Mr. Baldwin met with Mr. Van Sweringen and Mr. Wyer in Cleveland at a Brownsville Executive Committee meeting (R. 583-584). Two days later, Mr. Baldwin wrote from New York to Mr. Safford in Houston:

> "* * * I want to impress upon you *again* the fact that although it may necessitate a much more drastic curtailment of expense than you have ever had or anticipated, the NOT & M *must* earn and pay its dividend this year and have $100,000 left in addition * * *" (Ex. 135, R. 601). (Italics added.)

Mr. Safford replied that 1931 NOTM earnings were estimated at only 40% of the regular dividend, despite the fact that expenses were "very close to the irreducible minimum unless we make some further drastic reduction in service". Mr. Safford continued that the NOTM "program for Maintenance of Equipment" had been cut to "the lowest expenditure * * * since 1924". He concluded: "* * * We have felt that we have gone as deeply into these expenditures as we could without impairing the standard of service" (Ex. 135-137, R. 601).

Nevertheless, MOP compelled NOTM to pay its dividends regularly through 1931. Brownsville was used to provide the ostensible basis for such NOTM dividends.

On June 7, 1931, Brownville was caused to declare dividends of $655,079 (Ex. 113-119, 206, R. 576, 579, 674).

This was still not enough. Further correspondence passed between Mr. Baldwin and Mr. Safford (Ex. 172, R. 616).

On July 11, 1931—less than one month later—Brownsville, at MOP's dictation, declared a further dividend of 700%, amounting to $3,500,000, an amount greater than the sum of all Brownsville dividends for the preceding fifteen years * (Ex. 106, 206, R. 564, 674).

These Brownsville 1931 dividends totalling $4,155,000 were never paid in full ** (Ex. 102, R. 519, 415).

On auditing the NOTM accounts, the Commission held that the interlocking directors and officers knew, at the time, that these Brownsville dividends could not be paid, and that their inclusion in NOTM income was a violation of the Commission regulations. Accordingly, in 1936 the Commission disapproved the dividends and directed NOTM to write them off insofar as they were then still unpaid. NOTM complied (Ex. 62-64, R. 420-422).

Brownsville 1931 dividends were necessary for the continuance of NOTM dividends to MOP. NOTM's 1931 losses and charges to surplus would otherwise have impaired NOTM capital by $800,000 (Ex. 195, R. 663).

These 1931 dividends were declared though Brownsville suffered a deficit for the year and though its current liabilities exceeded current assets (Ex. 305, 309, R. 923, 927). The 1931 and earlier dividends aggregating $8,500,000 were declared though Brownsville's long-past-due indebtedness to NOTM for fuel, materials and supplies had been steadily mounting from less than $1,000,000 in 1924 to over $9,693,000 by 1931 (Ex. 102, 103, 189, 206, R. 519, 538, 660, 674).

Although Brownsville paid all its pre-1931 dividends to NOTM, Brownsville past-due bills to NOTM for essential supplies were left unpaid.

Such selectivity of payment had significant results. Declaration and payment of a Brownsville dividend increased

---

* At the time these dividends were declared, figures were already available revealing that Brownsville income from January 1 to May 31, 1931, was running 55% lower than 1930 (Ex. 312, R. 929).

** Indeed the inability to pay such dividends was the ostensible reason for the Browsville petition for reorganization under Section 77 (R. 444-445).

NOTM's paper income and surplus and made possible dividends to MOP. Payment of these past-due debts to NOTM would not have affected NOTM income or surplus.

(d) The Financial Plight of MOP and Alleghany

The Brownsville 1931 dividends occurred against the following background.

MOP was laboring under a swollen debt structure.

From March, 1927 to February, 1931, MOP sold to the public $206,000,000 of First and Refunding Mortgage Bonds * (Ex. 270-273, 275, R. 888). In 1927, MOP sold $95,000,000 of such bonds; in 1928, $25,000,000; in 1930, $25,000,000; and in 1931, $61,200,000 of such bonds (Ex. 271-275, R. 888). In addition, in 1931, MOP borrowed $23,400,000 in short term loans from J. P. Morgan & Co. (Sen. Rep. No. 25, 76th Cong., 3d Sess., Part 9, p. 14).

To accomplish the flotation of such new bonds, a showing of substantial MOP earnings was required. In addition, MOP annual carrying charges had increased by $7,500,000 in a decade (Sen. Rep. No. 25, 76th Cong., 3d Sess., Part 7, p. 19).

The predecessor of respondent Institutional Group stated that such "capitalization top heavy with debt" was the "major cause of the (MOP) bankruptcy" (*Senate Committee Hearings, supra,* 75th Cong., 1st Sess., Part 13, p. 5824 (1939)).

In addition, in the year ending July, 1931, $4,000,000 of MOP funds were used by Alleghany to purchase MOP stocks and IGN bonds. "While these purchases tended to bolster the market price of Alleghany securities, the effect on the carrier (MOP) was disastrous" (Sen. Rep. No. 25, 76th Cong., 3d Sess., Part 11, p. 34).**

---

* A substantial portion of these were used for refinancing both long and short term debt (Ex. 275, R. 888).

** This matter is treated more fully in footnote at page 48, *infra.*

MOP's position was further weakened in 1930 and 1931 by Alleghany's conduct in imposing "improvident" contracts on MOP involving a cash expenditure of $3,200,000 during this period.*

Under these burdens MOP's financial position had become critical by 1931. Traffic, moreover, was declining and the railroads of the country were in the midst of the depression (*Id.*, Part 11, p. 5).

As of December 31, 1930, MOP's current liabilities exceeded its current assets by more than $4,500,000. At the end of 1931, current liabilities exceeded current assets by almost $6,000,000 (*Id.*, Part 11, p. 5).

Indicative of MOP's straitened condition was the decision of the MOP Board of Directors at meetings in Terminal Tower, Cleveland, Ohio, on May 14 and July 14, 1931, to authorize the MOP Chairman (Mr. O. P. Van Sweringen) or MOP Treasurer (Mr. Wyer) to borrow a total of $7,300,000 to meet MOP's needs for current requirements and dividends (Ex. 156-160, R. 613).

MOP was further subjected to heavy pressure from its parent, Alleghany Corporation. Alleghany's position in 1931 was also serious. Its income from sources other than MOP was declining. Moreover, its control over MOP itself was at stake.**

---

* *In re Missouri Pacific R. R.*, 13 F. Supp. 888 (E. D. Mo. 1935). Payments under this transaction, and the $4,000,000 stock purchase campaign, were concealed (51st Annual Commission Report (1937), pp. 27-28; Sen. Rep. No. 25, 76th Cong., 3d Sess., Part 11, pp. 34, 30-33).

** The Alleghany holdings of MOP securities had been pledged as the principal security for an issue of Alleghany Bonds. Under the Alleghany trust indenture, the right to vote the MOP and other pledged securities passed to the indenture trustee if the pledged securities fell below 150% of the face amount of Alleghany bonds outstanding.

Alleghany thus was vitally concerned in the earnings reported by MOP, lest a drop in MOP income result in a decline in MOP security prices. Such a decline would depress the collateral below the critical 150% mark, and Alleghany would lose control of MOP (Sen. Rep. No. 25, 76th Cong., 3d Sess., Part 9, pp. 5-6).

The needs of MOP and Alleghany persisted until bankruptcy (Ex. 281, R. 900). Even as late as two days before MOP and NOTM filed petitions under Section 77, MOP compelled NOTM to pay $175,000 to MOP (Ex. 239, R. 791).

$7,800,000 of the MOP $10,565,227 claim arose during the period of Alleghany control, *i.e.*, after May, 1930 (Ex. 239, R. 754, 791).

Claim of $1,261,009 Saddled on NOTM

Included in the MOP Intercompany Claim is an item of $1,261,009. This represents a bookkeeping transaction to which NOTM has never consented and from which NOTM has not received a single penny to this date. Although described in the proof of claim as a "cash advance", no cash changed hands (Ex. 1, 240-241, R. 402, 794).

This purported obligation was saddled on NOTM through a series of journal entries in October 1932—in the darkest days of the depression and in the shadow of bankruptcy (Ex. 221-225, 231-232, 240-241, R. 701, 706, 794).

In October, 1932, MOP had unsecured claims against two subsidiaries, NOTM and IGN (Ex. 145, 155, R. 610, 613). In MOP System affairs, IGN was not regarded as a subsidiary of NOTM (R. 603).* The financial position of NOTM was much stronger than that of IGN.**

MOP—in need of loans from the Reconstruction Finance Corporation and the Railroad Credit Corporation (hereinafter called RFC and RCC)—sought to improve its position by shifting debtors. MOP moved the accounts of its subsidiaries like men on a chessboard.

---

* It should be noted that NOTM itself was acquired primarily because of MOP's desire to obtain control of IGN (R. 603-604).

** Thus, the first Plan made allocations to NOTM stockholders, but none to IGN general creditors (R. 20879, Appendix C).

MOP arbitrarily increased its claim against NOTM by $1,261,009. MOP simultaneously reduced its claim against IGN by the same amount.

As alleged consideration for this write-up of its Claim, MOP planned to have IGN assign to NOTM $1,261,009 of uncollectible claims which IGN had against certain NOTM subsidiaries—IGN sister companies. NOTM had not previously been liable for these claims.*

It was known at the time that these IGN claims were uncollectible.** Mr. Eckert, auditor of NOTM, so testified (R. 797, 1043).

Mr. Eckert, the then NOTM auditor and one of the few NOTM officers who was not also an officer of MOP, did not know all the details of this transaction until the District Court hearing, twelve years later (Ex. 52, R. 406). He testified:

> "* * * I have not seen any of these (journal) entries at all, this is news to me" (R. 702).

This transaction followed the usual pattern of MOP decisions with respect to the financial affairs of its subsidiaries.

Mr. Wyer, in Cleveland, wrote a directive on MOP stationery to Mr. Baldwin, pointing out that "the Chairman (Mr. Van Sweringen) has requested me to arrange this matter", and directing what was to be done. The MOP Board of Directors adopted Mr. Wyer's resolution, and the accounts were shifted (Ex. 221, R. 701, 703).

---

* The only possible claim that IGN may have had against NOTM amounted to $64,129. This was described as "unmatured interest accrued". The nature of this item was never disclosed (Ex. 223, R. 701). Against this, NOTM was not permitted to set off IGN's indebtedness to it in the sum of $41,115 for past-due interest on IGN 6% Adjustment Mortgage Bonds held by NOTM (Ex. 179, R. 632).

** For example, about $800,000 of these claims was due from a road, San Antonio, Uvalde & Gulf Ry., that had been in default for years on its first mortgage bond interest, which default totalled almost one million dollars at this time (Ex. 179, 223, R. 632, 701).

There was no pretense of corporate action by either NOTM or IGN. Corporate requirements were ignored. The MOP Board unilaterally sought to increase NOTM's indebtedness to it.

In this manner NOTM, with $19,000,000 of past-due indebtedness of its subsidiaries, most of which was uncollectible, was saddled with an additional $1,261,009 of uncollectibles (Ex. 69, 94, R. 432, 486).

Acquisition of North Texas "Feeder" Lines

The record contains evidence of other examples of financial burdens imposed on NOTM by MOP for the benefit of MOP.

NOTM was compelled to borrow and expend more than five and one-half million dollars to acquire North Texas "feeder" lines * for the benefit of MOP and IGN, and not for NOTM (Ex. 193, 233, R. 662). Some of these "feeder" roads do not even connect with NOTM or any of the Gulf Coast Lines, but tie in only with IGN (Ex. 213, R. 605-606, 678). These lines are on IGN territory on the route to St. Louis. As the maps in the record show, they are many miles to the north and well off the route of the Gulf Coast Lines (Ex. 213, R. 678).

It was recognized,** as the Commission found, that these five "feeder" lines "were really acquired for the benefit of

---

* These include the Asphalt Belt Ry., Asherton & Gulf Ry., the San Antonio Southern Ry., the San Antonio, Uvalde & Gulf Ry. and the Sugar Land Ry.

The cost of the Asphalt Belt Ry. Co. is given as $310,000 and that of the San Antonio Southern Ry. Co. as $600,000 (Ex. 193, 233, R. 662). Book value given to the Asherton & Gulf Ry. Co. securities was $439,000; the San Antonio Uvalde & Gulf Co., $3,038,000 and the Sugar Land Ry. Co., $1,163,000 (Ex. 98, R. 488).

** This had been recognized by the predecessor of respondent, Institutional Group (First Amended Plan of Reorganization, Protective Committee for MOP First and Refunding Bonds, p. 61; R. 20882).

the entire (MOP) system, * * * they have usually been operated at a deficit since acquisition" (*Missouri Pacific R. R. Reorganization*, 239 I. C. C. 7, 71 (1940)).

Mr. Wyer, himself, pointed out that such roads ran at a loss (R. 873).

The District Court, nevertheless, found that the "record contains no evidence tending to show that" such acquisition was "disadvantageous" to NOTM (R. 10).

Such expenditures for new roads were in addition to the millions of dollars of NOTM funds spent in the acquisition of other Texas roads in NOTM territory (Ex. 98, 193, 233, R. 10, 488, 662).

NOTM'S Inadequate Capitalization

Under the policies imposed by MOP, the resources of NOTM proved inadequate for the conduct of its business.

NOTM's resources were weakened by the $2,475,000 extraordinary dividends in 1924, declared as a part of the deal by which MOP acquired NOTM. Thereafter under MOP control, NOTM was further drained of funds by dividends well in excess of earnings.

In that framework, MOP compelled NOTM to embark on an expansion and improvement program.

In Mr. Wyer's elaborate description of the Baldwin Improvement Program, he made it completely clear that such expansion was as an integral part of the MOP System "which was being built up and expanded in a most unusual way". Mr. Wyer showed that the funds for such expansion were raised solely in "financing cycles" resulting in a tremendous increase in debt (R. 880, 888-896, 930-931).

As long as possible, these loans were refunded by public bond issues, with NOTM total bonded indebtedness climbing from $29,382,000 in 1924 to almost $43,000,000 four years later (Ex. 71, R. 432).

After the spring of 1928, NOTM was no longer able to borrow from the public (R. 1023-1024).* About the same time, NOTM became chronically short of cash working capital.** Its need for further borrowing persisted.

Under MOP control, NOTM annual interest charges almost doubled, rising from $1,463,000 in 1925 to $2,685,000 in 1932 (Ex. 99, R. 488). At the same time, NOTM consolidated income declined precipitously from an annual average of $2,400,000 for the years 1924 to 1926 to an average of $230,000 for the years 1927 to 1931 (Ex. 301, R. 914).

Despite NOTM's needs, MOP did not invest one additional penny in NOTM. The shares of NOTM stock acquired by MOP were all purchased from New York bankers or on the market; NOTM received no additional capital.

MOP's Domination of NOTM

The fiscal affairs of NOTM were directed by MOP officers and directors more than 1,000 miles from the nearest area served by NOTM.

The NOTM financial offices were not located in the NOTM main offices in Houston, Texas, but in New York City, in the financial offices of MOP. Subsequently, upon acquisition of MOP by Alleghany, the offices were transferred to Terminal Tower, Cleveland—the headquarters of the Van Sweringen-Alleghany empire (R. 590-597). These were the

---

* This was true not only because of changed market conditions. The NOTM First Mortgage Bond Indenture, in effect, made it impossible to sell any additional first mortgage bonds to the public.

** NOTM year-end cash which had averaged $992,000 during the early years of MOP control (1925 to 1927) dropped sharply to an average of $209,000 from 1929 to 1932 (Ex. 69, R. 432).

offices in which the decisions on NOTM financial matters were made * (R. 892).

Every meeting of the Board and Executive Committee of NOTM and Brownsville ** was held in New York City until control passed to Alleghany. After April 29, 1930, meetings were held in Terminal Tower, Cleveland (Ex. 173, 188, R. 617, 638).

It was in the New York offices that "the minutes of the meetings of the various companies, programs for the directors" were prepared. Problems such as whether NOTM was to borrow to pay its dividends, were described as the "requirements in the East" (R. 593-594).

The New York and Cleveland offices were in complete charge of the NOTM treasurer's bank accounts (R. 593).

The MOP officers in New York prepared plans, which were kept in MOP files, as to the programs to be imposed on NOTM. Thus, in 1929, Mr. Wyer, at the direction of the MOP chairman, estimated at the start of the year, the amounts to be lent to NOTM in order to enable NOTM to pay dividends to MOP throughout the year (Ex. 280, R. 896). Mr. Wyer estimated that the "advances required from" MOP would be $1,119,000 and that NOTM's "cash requirements" would include $1,038,000 for dividends. Mr. Wyer introduced this estimate as "typical" of the activities of the MOP New York office (R. 896-898).

The only contact that the NOTM main office in Houston, Texas, had with the NOTM financial office in New York and then Cleveland was through the MOP office at St. Louis (R. 500).

---

* E.g., the MOP Executive Committee met in New York at 11 A. M. on February 4, 1930. The NOTM Executive Committee met at 11.15 A. M. on the same day in the same place; precisely the same people were present at both meetings (Ex. 151, 152, R. 611-612).

** One Brownsville meeting was held in St. Louis.

Mr. Baldwin, president and operating head * of MOP a NOTM, with offices in Saint Louis, testified that his re tions with the financial offices in the East were:

> "• • • quite indefinite. Largely being a good fell I guess • • •" (R. 597).

Indeed, Mr. Eckert, the NOTM general auditor, not know how the NOTM financial office, in charge of Wyer, even functioned. Mr. Eckert never saw or check the books kept in the NOTM financial office. To the exte these books were checked at all, it was done by MOP vi president, F. P. Johnson, and the MOP St. Louis off (R. 497-502, 590-595).** Similarly, Mr. Johnson and MOP St. Louis offices issued the instructions which we followed by the NOTM bookkeeping staff in Houston (499, 1022, 1050-1051).

The long series of letters exchanged between Mr. Ba win in St. Louis and Mr. Safford in Houston with resp to dividends is demonstration of the manner in wh MOP officers determined the NOTM and Brownsville di dend policy (Ex. 120, 123-134, 137-140, R. 579, 581, 5 601, 610-616).

The expansion program imposed on NOTM was a cision by MOP officers as a part of the expansion of MOP system. To these officers, such as Mr. Wyer, NOT had no separate existence; it was "simply a part of Missouri Pacific System" (R. 930).

---

* The Senate Committee described the operating officials of MOP System as "mere supernumeraries". "Even the highest r road executive realized that they were little more than messeng for the holding (Alleghany) company interests" (Sen. Rep. No. 76th Cong., 3d Sess., Part 10, p. 30).

Mr. Baldwin acknowledged that Mr. Van Sweringen was "boss", and that when Mr. Van Sweringen gave him orders "always carried them out" (*Senate Committee Hearings, sup* 75th Cong., 1st Sess., Part 12, p. 5468).

** Some of the books kept in the eastern financial offices were ne audited by the MOP St. Louis office (Sen. Rep. No. 25, 76th Co 3d Sess., Part 11, pp. 17-18).

To finance this expansion program, NOTM had to borrow large sums. This was the policy determined by MOP, and the form such borrowings took—the financing cycles of Mr. Wyer—was determined by MOP officers and cast in the mold of the financing of the vast increase of the debt of MOP itself (R. 895).

When MOP made advances to NOTM, the same person drew the check as an officer of MOP and endorsed it for deposit as an officer of NOTM (Ex. 83, 239, R. 455, 791).

When NOTM made payments to MOP on the open account, MOP officers decided the allocation between principal and interest. The NOTM books were kept accordingly (R. 1022, 1045, 1050-1051).

The fundamental decision whether funds invested by MOP in NOTM should be denominated "advances" or additional stock was the decision of MOP.

In short, every financial act of NOTM was the act of MOP, and MOP determined the form in which intercorporate financial transactions were recorded on the books.

NOTM Open Account Debts Transmuted into Notes

Until a few weeks before bankruptcy, almost all NOTM "indebtedness" to MOP—whether cash advances or paper transactions—were recorded as open book accounts on the records of MOP. When MOP's financial position became increasingly desperate, and MOP could no longer obtain funds by the sale of additional securities or by borrowing from banks, it sought to obtain loans from the RFC and RCC.

For such loans the RFC and RCC required all the collateral on which MOP could lay its hands. When the bottom of the barrel of available collateral was reached in 1933, MOP arranged for the transmutation into two demand notes of open accounts constituting a large portion, but not all, of the MOP Claim. These notes were signed by Mr. William Wyer, as Treasurer of NOTM, and delivered to himself as Treasurer of MOP (Ex. 51-52, 348-349, R. 406).

The larger of these notes, for $7,456,726, was issued four weeks before bankruptcy. It and the other note *—issued shortly before—were immediately pledged, together with other collateral, by MOP to the RFC and RCC (R. 30, 86). $610,000 of the advances comprising the Claim were never pledged.

In *ex parte* proceedings, a division of the Commission hurriedly approved the issuance of the larger note, the RFC and RCC loans ** and the pledge to the RFC and RCC (*Missouri Pacific R. R. Reconstruction Loan*, 189 I. C. C. 286, 342, 549; *New Orleans, Texas & Mexico Ry. Notes*, 189 I. C. C. 600 (1933)).

After the District Court decision and before the Circuit Court decision in the instant case, the RFC and RCC claims against MOP were paid, pursuant to Court order, and the RFC and RCC claims and collateral, including the two NOTM notes, were surrendered to the Trustee of MOP (R. 1155, 1164). The findings with respect to the RFC and RCC became moot, and the RFC was stricken as a party to these proceedings † (R. 1348).

Physical Operations of MOP and NOTM

The physical operations of NOTM have no necessary relation to MOP's financial mismanagement. Considerable testimony was, nevertheless, presented by the Institutional Group in the District Court in an effort to demonstrate that the physical condition and operations of NOTM had been improved during the years of MOP control.

---

* This note had been issued for $2,498,500, the maximum amount permitted without consent of the Commission under Section 20(a) of the Transportation Act.

** This application was submitted on December 23, 1932, and decided January 4, 1933. Only MOP appeared (R. 110). MOP representatives included Mr. Wyer and Mr. Herbert Fitzpatrick, the close friend and adviser of Mr. O. P. Van Sweringen (Senate Committee Hearings, *supra*, 74th Cong., 2nd Sess., Part 2, p. 582).

† The RCC never was a party.

The Institutional Group put in evidence testimony and elaborate exhibits covering the operational history of NOTM from 1907. The District Court's findings were in accordance with such testimony (R. 13-17).

Under MOP control, a great improvement in the physical condition of the road had been achieved. This was paid for by a large increase of NOTM indebtedness (R. 13; Ex. 71, R. 432).

MOP engaged in an ambitious expansion and improvement program lasting from 1923 to 1930. This included the acquisition of the Gulf Coast Lines, IGN, and the Denver & Rio Grande Western, all of which were considered necessary for the strategic development of the MOP System (R. 10-11).

The District Court found that "road and equipment" had been "very substantially improved" (R. 13).

The District Court further found that MOP assistance had enabled the Gulf Coast Lines to maintain their competitive traffic position in the Rio Grande Valley and to reduce the schedule running time from the Rio Grande Valley to St. Louis. Under MOP control, the division of revenue received from perishable freight and arrangements for refrigerator cars improved (R. 14-16). The relation of freight car loadings to that of Class I railroads generally improved. Freight loadings from competitors of MOP declined after 1924. Receipts from MOP and IGN increased (R. 16-17).

Messrs. Rodgers, Kirkpatrick and Brown, witnesses for the Institutional Group, testified that an improvement in traffic and in the condition of locomotives, freight and passenger cars, and road had occurred during this period (R. 814-867, 933-954). Some of this testimony emphasized by the Institutional Group included: an increase in the percentage of creosoted ties, and of the tonnage of new rail laid per annum (although the tonnage of rail relaid declined), and a substantial decrease in the number of locomotive failures per mile (Ex. 249-251, R. 815, 829).

Additions and betterments included new lines and extensions, rail renewal projects, ballasting projects, bridges, trestles and culverts, and new station facilities (Exs. 255, R. 832).

Nature of the Proceedings Below

These proceedings involve the validity and priority of the claim asserted herein by MOP against NOTM. The litigation admittedly involves the first judicial determination of MOP's Claim (R. IV, 20-21). This is not a proceeding brought by NOTM to recover anything from MOP.

In the District Court, petitioner Comstock originally petitioned for leave to file objections to the MOP Claim in the name of the Trustee of NOTM (R. 247). He also filed objections to the then pending MOP Plan; of these, objection No. 19 and related objections repeated the objections to the MOP Claim contained in the first petition (R. 227, 232-233).

Counsel for respondents contended that the issues raised by these two documents of petitioner were identical, and that petitioner should be compelled to litigate his objections to the Claim in connection with the hearings on objections to the Plan (R. 338-339, 365-367). The District Court agreed (R. 367).

The validity and priority of the MOP Claim, attacked in Comstock's Objection No. 19, were thereafter the subject of a hearing by the District Court—separated from the hearings on the Plan of Reorganization—and were determined by a separate order, from which a separate appeal to the Circuit Court of Appeals was taken (R. 1, 7, 378). The proceedings were separated so that such separate appeal could be taken (R. 731).

The District Court held that the MOP Claim "should be allowed" and that Comstock's "objection to the claim of the Misouri Pacific against the NOTM should be overruled" (R. 31-34, 1111). The Circuit Court affirmed the District Court, holding that "the claim of Missouri Pacific was properly allowed" (R. IV, 27).

This is litigation * over such orders of allowance and is independent of any particular plan of reorganization.

The litigation over the MOP Plan of Reorganization pending at the time of the hearing on the MOP Claim ran its separate course. The District Court approved the Plan and appeals were taken by various parties to the Circuit Court of Appeals for the Eighth Circuit.

Respondents herein—such as the Institutional Group and the Alleghany Corporation—who had sponsored the Plan before the Commission and in the District Court abandoned the Plan. They informed the Circuit Court of Appeals that the Plan had become "unfair and inequitable". Together with other parties, they requested its remand to the Commission.

At the suggestion of the Circuit Court, the Commission submitted a brief; it urged the Court to remand the Plan for "reconsideration and revision". The Court did so on September 9, 1947. *Wright* v. *Group of Institutional Investors,* 163 F. (2d) 1022 (C. C. A. 8th, 1947).

The Commission has not yet held further hearings on this matter. At the request of the Institutional Group and Alleghany Corporation, such hearings have been twice postponed. Hearings are presently set for March 23, 1948.

The history of this Plan closely followed that of its only predecessor. After approval by the District Court, that plan was also abandoned by its sponsors, including the predecessor of the Institutional Group and at their request, in which others joined, remanded by the Circuit Court of Appeals for the Eighth Circuit. *Missouri Pacific R. R.* v. *Protective Committee,* 135 F. (2d) 741 (C. C. A. 8th, 1943).

---

* There were three other related appeals heard with the instant case before the Circuit Court on a consolidated record. Petition for writs of certiorari in these three cases was also granted on January 12, 1948. These three cases (Nos. 452-454 incl., October Term, 1947) are the subject of a separate brief filed herewith. They relate solely to a procedural question—the name in which the appeal from the District Court order of allowance should be taken.

The Errors Which Petitioner Intends to Urge

Petitioner specifies the following errors * which he intends to urge:

1. The court below erred in holding that the $10,565,227 claim of a parent corporation in reorganization against a dominated subsidiary is valid in its entirety and ranks prior to the claim of public investors, who are secured by the parent's pledge of the subsidiary's common stock, when:

(a) $2,795,000 of the Claim is based on eleven "advances" made by the parent over thirteen consecutive quarters which were matched within one to five days by dividends from the subsidiary to the parent in substantially equivalent amounts, which the subsidiary could not have otherwise paid.

(b) The parent did not permit the subsidiary to devote its earnings to its own needs, but caused the subsidiary to pay to the parent twenty consecutive quarterly dividends in excess of earnings, while the subsidiary was already borrowing heavily for an extensive expansion program.

(c) $1,261,009 of the Claim is based on the parent's write-up of the subsidiary's indebtedness through bookkeeping entries made six months before bankruptcy without the consent or approval of the subsidiary—the consideration for such write-up being the alleged assignment

---

* There were two issues on which respondents in the Circuit Court of Appeals below sought to dispose of the case without an adjudication on the merits of the MOP Claim. These were (a) laches and (b) the pledge by MOP, since redeemed, of two notes representing a portion of the MOP Claim.

The Circuit Court decided the case on the merits and thus, in our opinion, rejected these grounds. For this reason, we do not deem these grounds as errors of the Court below requiring specification. We refer to these matters only to avoid any possible technical contention by respondents. If any contention be made that such specification is necessary, we request this Court to regard this statement as the specification, if any, which may be required by the rules.

to the subsidiary of uncollectible claims in the same face amount, from which the subsidiary has not received one penny to this day.

(d) Much of the Claim represents funds supplied by the parent to the subsidiary, whose resources were inadequate to enable it to finance an extensive expansion program, after public borrowing became impossible, which funds were denominated by the parent as "advances" and never as additional capital investments.

2. The court below erred in allowing the disputed claim of a parent corporation against a dominated subsidiary, both being in reorganization with the identical trustee, over the challenge of public investors, when the subsidiary has never had the protection of a separate and independent trustee.

Summary of the Argument

POINT I—The MOP claim must be disallowed.

Corsicana National Bank v. *Johnson*, 251 U. S. 68, 90 (1919);
Pepper v. *Litton*, 308 U. S. 295, 306 (1939).

(a) $2,795,000 of the Advances in the MOP Claim Were Only Paper Transactions. $2,650,000 of Such Advances Were Repaid Almost Immediately.

(b) $1,261,009 of the Claim Represents an Invalid Write-up.

6 Williston, *Contracts* (Rev. Ed., 1938), §1870;
M. K. Goetz Brewing Co. v. *Waln*, 92 Neb. 614, 139 N. W. 230 (1912).

(c) The Balance of the Claim Must Be Disallowed.

Pepper v. *Litton*, 308 U. S. 295, 306 (1939);
Taylor v. *Standard Gas & Electric Co.*, 306 U. S. 307 (1939).

POINT II—The MOP claim, to the extent, not disallowed, must be subordinated.

Taylor v. *Standard Gas & Electric Co.*, 306 U. S. 307 (1939);
In re Commonwealth Light & Power Co., 141 F. (2d) 734 (C. C. A. 7th, 1944);
In re Indiana Service Corporation, S. E. C. Holding Company Act Release No. 7054, December 14, 1946, pp. 33-4;
Chesapeake & Ohio Ry. Purchase, 261 I. C. C. 239, 255 (1945);
Ecker v. *Western Pacific R. R.*, 318 U. S. 448, 479 (1943);
American United Mutual Life Ins. Co. v. *Avon Park*, 311 U. S. 138, 145 (1940);
In re Missouri Pacific R. R., 13 F. Supp. 888, 892 (E. D. Mo., 1935).

POINT III—Alleged insolvency of MOP and the fact that the public investors are claiming through NOTM common stock do not prevent subordination of the MOP claim.

(a) Parental Insolvency and Competing Creditors.

Taylor v. *Standard Gas & Electric Co.*, 96 F. (2d) 693, 700 (C. C. A. 10th, 1938);
In re Commonwealth Light & Power Co., 141 F. (2d) 734 (C. C. A. 7th, 1944);
In re Kentucky Wagon Mfg. Co., 71 F. (2d) 802 (C. C. A. 6th, 1934), cert. denied sub. nom. *Laurent* v. *Stites*, 293 U. S. 612 (1934);
Zartman v. *First National Bank*, 216 U. S. 134 (1910);
National Bankruptcy Act, §70;
2 Scott, *Trusts*, §307.

(b) Public Investors Claiming Through Common Stock.

POINT IV—The MOP claim may not be allowed in the absence of an independent NOTM trustee.

2 Scott, *Trusts*, § 170.23;
In re Stern, 144 Fed. 956, 959 (C. C. A. 8th, 1906);
Dudley v. *Mealey*, 147 F. (2d) 268, 272 (C. C. A. 2d, 1945), *cert. denied*, 325 U. S. 873 (1945);
Wilson v. *Continental Building & Loan Assn.*, 232 Fed. 824 (C. C. A. 9th, 1916);
In re Chicago R. I. & P. Ry., 110 F. (2d) 395 (C. C. A. 7th, 1940);
Pepper v. *Litton*, 308 U. S. 295, 306 (1939);
In re Central States Electric Corp., 143 F. (2d) 684 (C. C. A. 4th, 1944).

POINT V—An adjudication on the merits of the MOP claim is necessary.

(a) Laches.

Ecker v. *Western Pacific R. R.*, 318 U. S. 448, 479 (1943);
American United Mutual Life Ins. Co. v. *Avon Park*, 311 U. S. 138, 145 (1940).

(b) MOP's Pledge of the NOTM Notes.

Metropolitan Eelevated Ry. v. *Kneeland*, 120 N. Y. 134, 24 N. E. 381 (1890);
Gates v. *Ritchie*, 162 Ark. 484, 258 S. W. 397 (1924);
Uniform Negotiable Instruments Law, Sec. 58.

POINT I

The MOP Claim must be disallowed.

This Court has made it clear that a claim based on parent-subsidiary transactions is "presumptively fraudulent" and requires "rigorous scrutiny" before allowance.

Corsicana National Bank v. *Johnson*, 251 U. S. 68, 90 (1919);
Pepper v. *Litton*, 308 U. S. 295, 306 (1939).

In *Pepper* v. *Litton*, this Court, speaking of disallowance of claims of controlling stockholders, stated:

> "* * * Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the * * * [controlling] stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. * * * The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside. * * *" (308 U. S. at 306-307).

The MOP Intercompany Claim cannot survive such a test and must be disallowed.

(a) $2,795,000 of the advances in the MOP Claim were only paper transactions. $2,654,000 of such advances were repaid almost immediately.

$2,795,000 of the "advances" included in the Claim are sums which MOP "advanced" NOTM one day, and received back almost immediately in payments which MOP denominated "dividends". Actually, these paper transactions did not constitute advances. They were mere bookkeeping entries.

These paper transactions arose in eleven out of thirteen quarters from 1928 to 1931, when MOP arranged simultaneous MOP "advances" and NOTM "dividends" of approximately equivalent amounts (see pp. 9-11, *supra*). In these eleven paper transactions MOP advanced a total of $2,795,000, of which $2,654,000 was repaid almost immediately to MOP in the form of "dividends". Only $141,000 of these bookkeeping transactions may still be deemed open.

One example will suffice to demonstrate the invalidity of a claim based on such matching advances. On February 28, 1930, MOP advanced NOTM $260,000 with which NOTM paid its quarterly dividend of $259,576 one day later. Of such dividend, MOP received about $242,072 (Ex. 75-81, 177, 281, R. 453, 630, 900). MOP, however, does not now make a claim for the $18,000 which was not repaid. MOP now claims the full $260,000 together with interest of approximately $185,000, or a total of $445,000 for an advance of $18,000. MOP is seeking such a return as its reward for its stewardship as a fiduciary.

Good faith is no answer to the foregoing. It cannot validate a defective claim or justify a second repayment.

These facts are undisputed. Respondents' own exhibits and the District Court's findings show the dates and amounts of these "advances" and "dividends" (Ex. 281, R. 19, 900). The Circuit Court of Appeals did not discuss this issue.

The allowance of such a claim would be a repudiation of the salutary test enunciated by this Court in *Pepper* v. *Litton*.

Moreover, $825,000 of the foregoing $2,795,000 advances included in the MOP Claim were used for the purpose of paying illegal dividends. As Mr. Wyer admitted, the NOTM 1931 dividends—matching these $825,000 advances—were illegal (R. 296). On pages 8, 13, supra, we have

shown that the NOTM 1931 dividends were paid out of capital.*

Advances necessary for the payment of such illegal dividends cannot constitute the basis for a valid claim.

(b) $1,261,009 of the claim represents an invalid write-up.

Among the clearest instances of MOP mismanagement is the bookkeeping transaction in October, 1932, by which MOP, less than six months before bankruptcy, sought to saddle NOTM with a $1,261,009 obligation.

MOP wanted to improve its position by shifting debtors. It was dependent on RFC and RCC loans, and sought to dress up its books (Ex. 221, R. 701).

MOP decreased its claim against IGN, a weak debtor, and increased its claim against NOTM a stronger debtor, by the same amount. As alleged consideration for this write-up, MOP planned to have IGN assign to NOTM certain uncollectible claims belonging to IGN of equal amount. We have already seen on page 17 that these claims were uncollectible.

This was accomplished through a series of bookkeeping and journal entries and without one penny of cash changing hands (Ex. 221-225, 231-232, 240-241, R. 701, 706, 794).

The Record contains no evidence that the directors of NOTM and IGN ever took any corporate action. The Record shows only that the MOP Board of Directors approved this transaction (Ex. 226, 232, R. 706). But it is clear that a corporate resolution by MOP alone is not sufficient to bind either NOTM or IGN.

---

* The impairment of NOTM capital was even greater by reason of the following. The total of debts due NOTM from Brownsville and other subsidiaries had mounted from $2,680,000 in 1924 to over $16,000,000 by 1931 (Ex. 69, 94, R. 432, 486). These past-due debts, totalling 23% of all NOTM assets by 1931, were nevertheless carried at face value on the NOTM books. If even a modest reserve had been set up, NOTM's book surplus would have disappeared.

Unless the party alleged to have become substituted as the debtor so agrees, there obviously can be no novation.

6 Williston, *Contracts* (Rev. Ed. 1938), § 1870;
M. K. Goetz Brewing Co. v. *Waln*, 92 Neb. 614, 139 N. W. 230 (1912).

As the Supreme Court of Nebraska said in the *Waln* case:

> "It is elementary that, in a case of this kind, there can be no novation unless the party whom (sic) it is asserted assumed and agreed to pay the debt became unconditionally bound to the creditor to pay the debt of the original debtor" (92 Neb. at 620).

Even if formal action had been taken, the legality of this transaction would not be assured because of the domination by MOP. It does not carry "the earmarks of an arm's length bargain" required by *Pepper* v. *Litton*.

Respondents urged that NOTM had not been damaged by this transaction because the debts were due from NOTM wholly owned subsidiaries, and on a consolidated basis the Gulf Coast Lines owed not one penny more after the transfer (Institutional Group Brief, C. C. A., p. 23). The District Court found that the transaction had not been shown to have "adversely affected" NOTM (R. 22). The Circuit Court below is silent on this matter.

Such conclusions are irrelevant. The transaction allegedly giving rise to MOP's claim is unenforceable. MOP's claim is, therefore, invalid, irrespective of prejudice to NOTM.

As a fact, NOTM was prejudiced. The whole purpose of the transaction was to increase MOP's claim against NOTM. NOTM—not previously liable for these debts—was to be substituted as debtor for another. NOTM was required to bear the risk of uncollectibility of the IGN claims.

At this time, NOTM already had claims against its subsidiaries in excess of $19,000,000 which were long past due and which it was unable to collect (Ex. 69, 94, 202-205, R. 432, 486, 671-672). This transaction added an additional $1,261,009 to its burden.*

The District Court found that all advances from December, 1931, to bankruptcy were for operating expenses, interest and sinking fund installments (R. 19). There is nothing in this bookkeeping entry, included in the claim as a "cash advance", which even remotely justifies such a characterization.

It is immaterial whether or not Mr. Wyer, common treasurer of MOP and NOTM, may have written this transaction into the respective accounts of the two corporations—in keeping with the practice of making the books of MOP and its subsidiaries agree in every minor detail. As Mr. Justice Roberts said in the *Deep Rock* case:

> "All the documentary evidence came from the books and records of Standard and Deep Rock * * *. The book entries were made under the direction of Standard's Auditing Department, which supervised the Auditing Department of Deep Rock, and it is not surprising, therefore, that the books of the two companies agree with respect to all items" (306 U. S. at 311).

All we have to do is to substitute MOP for Standard and NOTM for Deep Rock and we have the precise situation of the case at bar.

This saddling transaction is but one example of Mr. Wyer's bookkeeping. We have already seen how MOP and Alleghany engaged in bookkeeping devices to the

---

* NOTM, moreover, owned all the mortgage bonds of these companies, as well as other large claims against them. These were already uncollectible and the stock of these roads was worthless. An addition of further uncollectible items was of illusory value in improving NOTM's position as a stockholder.

detriment of subsidiaries, e.g., imposition of burdensome contracts and MOP's costly purchases of its own securities at Van Sweringen direction (see pp. 14-15). Mr. Wyer's bookkeeping played a prominent role in these transactions. Before the Senate Committee, Mr. Wyer admitted that such bookkeeping had been false in numerous respects (Senate Committee Hearings, *supra*, 75th Cong., 1st Sess., Part 12, pp. 5059-5063, 5079).

President (then Senator) Truman, who was conducting the hearing, replied to a comment by Mr. Wyer: "Mr. Wyer • • • this statement is exactly in line with your bookkeeping. I do not think it conveys the truth • • •" (*Id.*, Part 12, p. 5269).

(c) The balance of the Claim must be disallowed.

As we have seen, almost 40% of the MOP Claim is invalid. This consists of the $2,654,000 of matched advances and dividends, and the $1,261,009 bookkeeping entry. We submit that the balance of the Claim must be disallowed.

The fiduciary parent has the burden of establishing its claim. *Pepper* v. *Litton*, 308 U. S. 295, 306 (1939).

Part of the remaining advances were made not for the benefit of NOTM but for the benefit of MOP. For example, MOP caused NOTM to acquire a number of North Texas Lines which the Commission recognized "were really acquired for the benefit of the entire MOP system. They have usually been operated at a deficit since acquisition." *Missouri Pacific R. R. Reorganization*, 239 ICC 7, 71 (1940). Such roads ran at a loss (R. 873).

Part of the MOP advances were made to cover interest on the NOTM bonds issued to acquire these lines and to cover other operating deficits (R. 19). How much of the balance of the Claim is so attributable is not disclosed. One fact is clear; a substantial part of the balance is attributable thereto.

The entire course of the history of the operation of NOTM as a part of the MOP system makes it impossible to determine on the record how much, if any, of the balance of the Claim is valid. The language of this Court in the *Deep Rock* case is particularly apposite:

> "It is impossible to recast Deep Rock's history and experience so as even to approximate what would be its financial condition at this day * * * had its fiscal affairs been conducted with an eye single to its own interests." *Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307, 323 (1939).

Under all the circumstances, we submit that the entire Claim must be disallowed. To the extent, if any, that the Claim is not disallowed, it must be subordinated as we now proceed to show.

POINT II

The MOP Claim, to the extent, if any, not disallowed, must be subordinated.

Under the decision of this Court in the *Deep Rock* case, *Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307 (1939), the MOP Intercompany Claim—to the extent, if any, not disallowed—must be subordinated to the claim of public investors holding MOP 5¼% Secured Bonds.

The question before this Court is whether the *Deep Rock* doctrine—good law and good morals—is to be whittled away.

The *Deep Rock* case

Both the parent, Standard, and its dominated subsidiary, Deep Rock, had been in Section 77B proceedings.

Standard asserted a claim against Deep Rock for advances totalling $9,300,000. This claim was resisted by the Deep Rock independent trustee and Deep Rock public

preferred stockholders. After prolonged hearings, Standard proposed a compromise. It excluded every questionable item and reduced its claim to $5,000,000, based solely on advances for the undisputed benefit of Deep Rock.

After rejecting one Plan based on this compromise, the District Court allocated most of the new Deep Rock common stock to Standard for its compromise claim, and a small portion of new common to the public preferred stockholders. On appeal by a minority group of preferred stockholders, the Circuit Court affirmed.

This Court reversed, holding that it had been an abuse of discretion to fail to subordinate the entire Standard claim to the claim of the public preferred stockholders. The Court concluded:

> "Deep Rock finds itself bankrupt not only because of the enormous sums it owes Standard but because of the abuses in management due to the paramount interests of interlocking officers and directors in the preservation of Standard's position, as at once proprietor and creditor of Deep Rock" (306 U. S. at 323).

The *Commonwealth* case

The outstanding application of the *Deep Rock* doctrine is found in the decision of the Circuit Court of Appeals for the Seventh Circuit in *In re Commonwealth Light & Power Co.*, 141 F. (2d) 734 (C. C. A. 7th, 1944).

In the *Commonwealth* case, the parent corporation, Inland, owning all the stock of its newly organized subsidiary, Michigan, pledged the stock to secure a public issue of Inland bonds.

Years later, Inland (the parent) went into Section 77B reorganization proceedings. It then had a $620,132 claim against Michigan for advances.

The District Court subordinated the parent's claim to the claim of Inland public bondholders holding the pledged Michigan common stock.

The Circuit Court of Appeals affirmed, concluding that:

> "Michigan was under the complete control and domination of Inland; that
>
> it was insufficiently capitalized; that
>
> Inland failed to make provision for sound financing for Michigan's extensive rehabilitation and expansion program; and that
>
> Michigan, upon the demand of Inland, declared dividends which were paid to Inland by open account borrowings from Inland * * *" (141 F. (2d) at 739).

The Circuit Court of Appeals below did not even refer to the *Commonwealth* case.

The Principles Underlying Subordination

Subordination was decreed in the *Deep Rock* and *Commonwealth* cases because of the parent's violation of its fiduciary obligations towards the dominated subsidiary. As was stated in the *Commonwealth* case:

> "* * * Inland, by reason of its entire ownership and control of Michigan, occupied a fiduciary position requiring scrupulous observance of its obligations to safeguard and preserve the interest of Inland Bonds and owed to its bondholders a duty not to impair the value of the Michigan stock * * *. And where there is a violation of those principles, equity will undo the wrong" (141 F. (2d) 734, 736-737).

In both cases, the breach of fiduciary duties arose from the parent's mismanagement of the subsidiary's financial affairs.

(1) Control and Domination of the Subsidiary

In the *Deep Rock* and *Commonwealth* cases, as in the instant case, the parent's control of the subsidiary stemmed from its ownership of all or almost all the subsidiary's voting stock.

In the *Deep Rock* case, this Court pointed out how Standard—the parent—implemented its control.

> "Standard's officers, directors and agents always constituted a majority of the Board. * * * A majority of Deep Rock's officers were officers or directors of Standard * * *. All of the fiscal affairs of the debtor were wholly controlled by Standard which was its banker and its sole source of financial aid" (306 U. S. at 310-311).

MOP went even farther. Upon acquisition, MOP officers and directors occupied a large majority on the NOTM Board of Directors, and most NOTM offices. By 1929, MOP directors occupied each place in the NOTM Board and all the principal offices of NOTM (Ex. 5-61, R. 403-406).

NOTM had no independent directors or principal officers. Its every act and decision was the act of MOP.

The character of MOP control has been indicated by the predecessor of the leading respondent, Institutional Group, which stated: "Financial management has been unsatisfactory * * *. Furthermore, the interests which took control of the railroad in 1930 (Alleghany) brought about transactions of doubtful legality, which caused great loss" (*Senate Committee Hearings, supra,* 75th Cong., 1st Sess., Part 13, p. 5824 [1939]).

(2) Dividends for Benefit of Parent

Outstanding among the financial mismanagement in the *Deep Rock* and *Commonwealth* cases was the continued insistence upon dividends from the subsidiary for the benefit of the parent.

Dividends and borrowing

In the *Deep Rock* case, this Court emphasized * as a ground of subordination that:

---

* The Court's language makes inapplicable the cases relating to the legality of the payment of dividends to public stockholders out of isolated borrowings from third persons.

> "* * * dividends were declared in the face of the fact that Deep Rock had not the cash available to pay them and was at the time borrowing in large amounts from * * * Standard. * * *
>
> "It is evident that they would not have been paid over the long course of years by a company on the precipice of bankruptcy and in dire need of cash working capital" (306 U. S. at 317, 323).

The *Commonwealth* case also involved dividends siphoned from a subsidiary lacking cash and already borrowing large amounts. The technique in the *Commonwealth* case of matching simultaneous loans from the parent with dividends to the parent finds a striking parallel in the instant case.

Thus, in both the *Commonwealth* case and the instant case, the parents—Inland and MOP—made "advances", quarter in and quarter out through 1929, 1930 and 1931, to their respective subsidiaries on one day which were matched by "dividends" to the parents in relatively equivalent amounts a few days later.

In the *Commonwealth* case, this bookkeeping matching occurred as follows:

Amount of Advance	*Date of Advance*	*Payment of Dividend*	*Amount of Dividend*
$29,576	June 25, 1929	5 days later	$29,576
29,576	Sept. 26, 1929	4 days later	29,576
60,000	Jan. 6, 1930	6 days before	51,844
8,000	June 25, 1930	5 days later	7,663
40,000	Oct. 9, 1930	9 days before	38,313
59,000	Mar. 25, 1931	6 days later	34,000
40,000	June 20, 1931	10 days before	34,000
45,000	Sept. 24, 1931	5 days later	34,000
25,000	Dec. 26, 1931	5 days later	34,000
82,500*	Mar. 30, 1932	1 day later	34,000

(S. E. C. Ex. 28, *Commonwealth Record*, C. C. A. 7th, Vol. II, pp. 985-7.)

---

* This item bears a notation also referring to bond interest.

On page 10, *supra*, appears a chart of almost simultaneous MOP advances and NOTM dividends in relatively equivalent amounts. Language cannot state more emphatically than these two charts the parallel between the *Commonwealth* case and the instant case.

If MOP or Inland had not made these advances, cash payment of the dividends would have been impossible. The same condition existed in the *Deep Rock* case. NOTM, Michigan and Deep Rock did not have the funds (Ex. 75-79, R. 453; S. E. C. Ex. 28, *Commonwealth* Record, C. C. A. 7th, Vol. II, p. 986; 306 U. S. at 317, 323).

S.E.C. policy on matching loans and dividends

The S.E.C. condemned such matching loans and dividends in the *Commonwealth* case.

In its subsequent decision in the *Indiana Service* case, the S.E.C. again attacked a claim of a parent for loans to a dominated subsidiary, matched by almost simultaneous dividends to the parent. The S.E.C. stated in language strikingly applicable to the case at bar:

> "While some of the loans made by Utilities (the parent) to Indiana Service were more or less contemporaneous with the preferred and common stock dividend payment dates, Utilities (the parent) states that there is no evidence that such advances were made in whole or in part for dividend purposes.
>
> "• • • We think it is fairly obvious that the loans made to Indiana Service (the subsidiary) concurrently with the payment of common stock dividends to Utilities when Indiana Service was in need of funds for other purposes were for the purpose of converting earned surplus to notes payable. On the basis of the foregoing, we would have no difficulty in finding a proper basis for subordination. • • •" (*In re Indiana Service Corporation*, S.E.C. Holding Company Act Release No. 7054, December 14, 1946, pp. 33-4).

Ratio of dividends to earnings

In the *Deep Rock* case, the dividends condemned by this Court as requiring subordination totalled less than 60% of Deep Rock earnings (*Deep Rock Record*, Sup. Ct., Vol. II, pp. 649-50).

In the *Commonwealth* case, the Court criticized dividends of 80% of earnings.

The situation in the case at bar is even stronger. During the entire period of MOP control, NOTM was caused to declare dividends of over 133% of its own earnings, and over 130% of consolidated earnings (Ex. 195, 301, R. 663, 914).

From 1927 to bankruptcy, NOTM dividends exceeded consolidated NOTM earnings in each and every year. Such NOTM dividends totalled $5,190,000 or over 450% of the $1,150,000 consolidated earnings for these dividend years (Ex. 301, R. 914).

By compelling NOTM to pay dividends well in excess of earnings, MOP actually decreased its investment in NOTM and prejudiced the equity of the pledged stock, in violation of the provisions of the MOP 5¼% Secured Bond Trust Indenture.*

Dividends paid while subsidiary borrowing for an expansion program

In the *Commonwealth* case, the Court emphasized the wrongfulness of compelling dividends "at a time when Michigan (the subsidiary) was engaged in an extensive rehabilitation and improvement program which it was unable to finance out of its own income * * *" (141 F. [2d] at 738).

---

* Article V of such Trust Indenture provided:

"(m) The Railroad Company (MOP) will not do or perform, or voluntarily permit to be done or performed, any act or thing by which the validity or priority of this indenture and pledge hereunder of the Pledged Stock, as herein provided, can or may be in any way or manner impeached" (R. 12).

The *Deep Rock* case also makes it clear that such dividends by a subsidiary are wrongful when the subsidiary is already borrowing to maintain its operations and an expansion program (306 U. S. at 317).

NOTM, likewise, was caused by MOP to pay dividends when it was already borrowing for an expansion and improvement program directed by MOP.

Compulsory dividends while borrowing for expansion are especially detrimental to the subsidiary. It is prevented from devoting earnings to the expansion program which is straining its resources. Its dependence on borrowed funds is increased.

Not only was MOP's conduct more improper in this respect than that of Standard and Inland, but the 1931 NOTM dividends were actually illegal (R. 296).

This Court made it clear that dividends were wrongful when detrimental to the subsidiary, whether or not they are illegal.

> "Whatever may be the fact as to the legality of such dividends judged by the balance sheets and earnings statements of Deep Rock, it is evident that they would not have been paid over a long course of years by a company on the precipice of bankruptcy and in dire need of cash working capital" (306 U. S. at 323).

Respondents urged in the court below that petitioner cannot be heard to complain because a fraction of the NOTM dividends may have helped MOP to pay interest on the 5¼% Secured Bonds. This is immaterial. This precise situation existed in the *Commonwealth* case, and did not prevent subordination. Moreover, in the *Deep Rock* case itself, the millions of dollars of dividends on the preferred stock, cited by the Court as an outstanding example of Standard mismanagement, were paid not indirectly but directly to the very class of holders which later successfully sought subordination of the Standard claim.

(3) Inadequate Capitalization and Unsound Financing for Expansion

Among the elements of the financial mismanagement in the *Deep Rock* and *Commonwealth* cases was the parent's policy of running the subsidiary without resources adequate for the conduct of its business. Such inadequacy of capitalization compelled the continued advances from the parent that marks those two cases and the case at bar. Advances under such circumstances do not attain the status of a debt, prior to the claim of public investors, in the event of reorganization.

Under Standard control, the financial resources of Deep Rock were not adequate, although its original financing provided $6,700,000 cash working capital. Deep Rock was forced to borrow constantly.

This Court made it clear that such continued necessity to borrow was what it meant by inadequate capitalization. It stated:

> "* * * So inadequate was Deep Rock's capitalization that, in the period from organization to 1926, the balance due on open account to Standard grew to more than $14,800,000" (306 U. S. at 315).

The resources of Michigan were also inadequate. Its financial history consisted of a dreary cycle of bank loans and advances from its parent (Inland) which in turn were refunded as long as possible by public security issues. Michigan's publicly held bonds and preferred stock increased. Michigan's cash position was weak and its open account indebtedness to Inland mounted.

Under MOP control, NOTM also suffered from insufficient capitalization. Its dependence on borrowed funds had been intensified by the very transaction by which MOP acquired NOTM, compelling NOTM to borrow to pay the large dividends constituting a portion of the purchase price. Thereafter NOTM was forced to borrow continuously and heavily (Ex. 281, R. 900).

From 1924 to 1928, these sums were raised by public bond issues, increasing NOTM total bonded indebtedness by $13,500,000 or 46% in four years (Ex. 71, R. 432).

After the spring of 1928, NOTM was no longer able to borrow from the public (R. 1023-1024). It could only borrow from MOP and its open account debt to MOP rose steadily (Ex. 239, R. 791). Such NOTM borrowings from MOP ranged from $2,610,000 in 1929, one of the few years in which NOTM showed net earnings, to $1,400,000 in 1930, and almost $3,000,000 in both 1931 and 1932. Such repeated borrowing in good years and bad demonstrated MOP's failure to provide NOTM with sufficient capital to conduct its business (Ex. 281, R. 900).

Mr. Wyer himself stressed that the program imposed on NOTM "required intensive financing with outside capital or new capital" and that the MOP policy was to raise such capital not through additional equity investment, but through "short term loans and ultimately the sale of debt" (R. 930). Thus, in Mr. Wyer's own words, we have a vivid picture of NOTM's lack of resources and MOP's refusal to make any additional equity investment.

In contrast, both Standard and Inland made additional stock investments in their respective subsidiaries. Thus, Standard took additional Deep Rock common stock as payment for advances to Deep Rock totalling more than twice its later claim. Similarly, Inland surrendered advances equal to almost three-quarters of its subsequent claim for additional Michigan common stock.

(4) Other Aspects of Financial Mismanagement

In each of these three cases, the exploitation of the subsidiary was prompted by the needs of the holding company systems of which parent and subsidiary alike were part.

In the *Commonwealth* case, the parent—Inland—was draining funds from Michigan as a result of the pressure from its parent, a holding company, in the Insull Utility Empire. The *Deep Rock* case arose out of another utility empire, that of H. M. Byllesby & Co.

As we have seen, the bulk of the MOP Claim arose during the period of Alleghany control of MOP.

The Commission has aptly summarized the type of pressure * exerted by Alleghany. It stated that Alleghany:

> "* * * for its own purposes caused or permitted carrier corporations which it controlled to pay dividends when they were not being earned, or to pay dividends when they were under a heavy burden of debt, when traffic was declining, and earnings were decreasing, notwithstanding scrimping of maintenance." *Chesapeake & Ohio Ry. Purchase*, 261 I. C. C. 239, 255 (1945).

Such mismanagement of NOTM was not restricted to wrongful dividends, lack of adequate resources to conduct its business and failure to provide sound financing for the expansion program.

---

* The Senate Committee reported on one instance of such pressure as follows:

"Less than half a year after it had procured control of the Missouri Pacific system, Alleghany Corporation * * * used funds from the treasury of the Missouri Pacific itself to purchase Missouri Pacific stocks and the bonds of a Missouri Pacific subsidiary.

"* * * For a year and a half the ownership of the purchased securities was kept in suspense * * *. Thus, if they appreciated in value, the Van Sweringens were free to assign them to a company in which they had a large personal interest; while if the securities declined in value, they could be assigned to a company in which the Van Sweringen interest was attenuated. The securities in fact declined in value; and the Van Sweringens thereafter insisted that they had been purchased for the account of a Missouri Pacific subsidiary * * *.

"To keep the transaction secret a variety of devices was used. * * * the president of the railroad was not informed of the program until it was nearly completed; and the companies engaged in the operations repeatedly and consistently falsified their books.

"* * * On the basis of the false accounting, false reports were submitted to several State public service commissions and to the Bureau of Internal Revenue. Material information was withheld from the Interstate Commerce Commission and from the Federal bankruptcy court.

"* * * The Missouri Pacific paid some $4,000,000 for securities, now worth virtually nothing at all to it. Transactions like these helped bring about the insolvency of the railroad" (Sen. Rep. No. 25, Part 11, 76th Cong., 3d Sess., p. 34).

As previously set forth on pages 16-18, the Claim itself is based in part on the invalid bookkeeping transaction, less than six months before bankruptcy, by which MOP wrote up the indebtedness of NOTM by $1,261,009.

A further instance is the expenditure of five and one-half million dollars of NOTM funds for the acquisition of North Texas "feeder" lines for the benefit of MOP and IGN, not that of NOTM, referred to on pages 18-19.

We repeat the language of this Court in the *Deep Rock* case:

> "It is impossible to recast Deep Rock's history and experience so as even to approximate * * * its financial condition * * * had it been adequately capitalized and independently managed and had its fiscal affairs been conducted with an eye single to its own interests" (306 U. S. at 323).

Unlike the *Deep Rock* Case, the MOP Claim Is Itself Defective

In the *Deep Rock* case, every questionable transaction had been eliminated from the Standard claim. This Court, nevertheless, insisted on subordination of its claim consisting solely of undisputed advances for the benefit of Deep Rock.

In the instant case, the MOP Claim is itself defective. As we have seen, it is composed in large measure of illegal and unenforceable items, and must be disallowed in its entirety. To the extent, if any, that the claim is not disallowed, the application of the doctrine of subordination is all the more compelling.

Respondents contended on two grounds that the *Deep Rock* doctrine is inapplicable in the instant case: (a) the operational benefits to NOTM, and (b) the findings of the Commission.

Operational Benefits No Bar to Subordination

Respondents contended below that the *Deep Rock* doctrine was inapplicable because of the operational benefits received by NOTM under MOP ownership. These factors, however, are irrelevant.

All these alleged benefits cannot purify one wrongful dividend. This proposition should be obvious. Any other conclusion would create a new principle in our law that the general conduct or good faith of a fiduciary will excuse specific breaches of its fiduciary obligations.

The Baldwin Improvement Program need not have been affected one iota, if not a single dividend was paid by NOTM to MOP. Not one rail less would have been laid nor one trestle less would have been constructed.

Both the *Deep Rock* and *Commonwealth* cases make it clear that operational benefits do not prevent subordination.

In the *Deep Rock* case, there was evidence of a considerable physical improvement of Deep Rock. Additional oil properties were acquired and extensions erected for the benefit of Deep Rock (306 U. S. at 317, 319). In 1927 alone, Deep Rock improvements and additions amounted to more than $2,700,000 and in 1928 alone more than $1,700,000 (*Deep Rock* Record, Sup. Ct., Vol. III, pp. 106, 108; Trustee's Exs. H, I).

Similarly, in the *Commonwealth* case, there was not one allegation of operational mismanagement. It was not disputed that Michigan had received substantial operational benefits from the Inland "extensive rehabilitation and expansion program". The proponents of the Inland claim strongly argued that the *Deep Rock* doctrine could therefore not be applied (*Middle West Corp.* and *Bachrach Brief*, C. C. A., p. 27). The Circuit Court of Appeals rejected that argument.

Respondents also argued that if MOP had intended to mismanage NOTM, it could have more easily achieved its results through its dealings with NOTM in respect to main-

tenance, rentals, and traffic (Institutional Group Brief, C. C. A., p. 15). This very type of argument was made in the *Commonwealth* case. It was argued there that Inland's lack of exploitation of Michigan was demonstrated by the fact it had not despoiled Michigan through unfair leases, management fees, and intercompany security sales (*Middle West Corp. Reply Brief*, C. C. A., p. 5). This argument was rejected there and should be rejected here.

In any event, the Baldwin-Safford correspondence discloses MOP's primary interest in drawing off dividends from NOTM, not in improving the physical condition of NOTM. Thus, Mr. Safford acknowledged that maintenance and improvement expenditures had been cut to the "irreducible minimum" in an attempt to make possible the continued flow of dividends to MOP (Ex. 135-137, R. 601). (See page 12.)

The Findings of the Commission

Respondents sought below to distinguish the *Deep Rock* case on the ground that Division 4 of the Commission prior to bankruptcy had made certain findings with respect to the MOP advances (Institutional Group Brief, C. C. A., p. 55). Both the District Court and the Circuit Court relied on such Commission findings (R. 1110, R. IV, 16).

No significance may properly be given to such findings. The fact is that the Commission itself, in considering the MOP Plan of Reorganization gave no weight to the hasty and *ex parte* findings of Division 4.

The Commission itself said that the determination of the validity of the claim is a matter "for litigation in the Courts" (R. 20842).

An independent judicial determination of the validity and priority of the MOP Claim must be made.

Ecker v. *Western Pacific R. R.*, 318 U. S. 448, 479 (1943);

American United Mutual Life Ins. Co. v. *Avon Park*, 311 U. S. 138, 145-146 (1940).

The Division 4 decision was reached on the basis of financial statements sworn to by Mr. Wyer and criticized by the late Commissioner Joseph B. Eastman and other officials (Senate Committee Hearings, *supra*, 74th Cong., 2nd Sess., Part 2, p. 544 (1938); 75th Cong., 1st Sess., Part 3, pp. 1116, 1139 [1938]).

The Commission regarded such criticized financial statements of Mr. Wyer as of sufficient importance to be called to the attention of the Congress in its annual report four years later; it stated:

> "The Alleghany Corporation is a holding company which had stock control of the Missouri Pacific Railroad Company and through a subsidiary purchased certain terminal-railway properties. * * * That railroad company contracted to purchase the properties from the subsidiary subject to our approval, but it made certain payments on the purchase price in advance of such approval and under the contracts it was liable either on the purchase price or as a guarantor against damage in the event of our disapproval for not less than $16,000,000. This liability was not shown in the annual reports filed with us * * *, and in these reports $3,200,000 * * * was shown in * * * 'Special deposits', although it had been paid out and was not on deposit. * * * In connection with applications of the Missouri Pacific for loans from the Reconstruction Finance Corporation, balance sheets which failed to disclose the liability under the contracts and included the payments in 'Special deposits' were filed with the Reconstruction Finance Corporation and with us and were sworn to by the treasurer of the railroad company. Furthermore, in connection with an application by the latter for authority to issue securities we asked for a breakdown of an estimate of needed capital expenditures, and in a statement filed by the same officer a proposed payment under the above mentioned contracts was included in a total for 'Additions and betterments'. * * *
>
> "As stated above, these are merely illustrations of incorrect and misleading reports out of several disclosed at the hearing."

(51st Commission Annual Report (1937), pp. 27, 28.)

The treasurer above referred to was Mr. Wyer. The MOP applications for RFC loans above referred to are the applications which resulted in the findings on which the Courts below relied.

In the "Terminal Shares" matter in this reorganization, referred to immediately above, the late Judge Faris condemned the management of Alleghany and MOP*; he stated:

> "* * * For me it is plain that the Congress intended to stop a practice among railroads and their exploiters and manipulators, which has had much to do with making the financial history of railroads the most indecent and sordid chapter ever written in the history of this or any other nation." (*In re Missouri Pacific R. R. Co.*, 13 F. Supp. 888, 892 [E. D. Mo., 1935]).

The District Court below said that it was "impressed by the fact that almost all of the transactions of which Comstock complains were entered into only after notice to, and with the approval of, the Interstate Commerce Commission" (R. 1110). This statement is without support. The matching of "advances" and dividends, the 1932 saddling transaction, the Brownsville dividends of 1931, which the Commission itself held to be in violation of regulations, and other instances of MOP mismanagement were all imposed on NOTM without notice to the Commission or its approval.

Damage to 5¼% Secured Bondholders

The Circuit Court was influenced to conclude that the *Deep Rock* doctrine was inapplicable by the fact that the

---

* This arose on the application of the RFC—then a claimant—to require the MOP Trustee to disavow or rescind what Judge Faris subsequently found to be "improvident, unfair, unlawful and overreaching" contracts imposed on MOP by Alleghany.

The RFC application and brief attacked both Alleghany and Mr. Wyer's testimony in support of such contracts (RFC Brief before Special Master, pp. 66, 77-78).

NOTM stock "has been kept intact and of recognized value through depressions which wiped out vast amounts of such securities" (R. IV, 27).

In the *Commonwealth* case, however, subordination was decreed although the subsidiary—Michigan—never went into reorganization and although Michigan stock was then being sold for over $1,000,000.

The injury to the 5¼% Secured Bondholders by MOP mismanagement is manifest. MOP's wrongful conduct has unquestionably diminished the size of the NOTM estate and impaired the value of NOTM stock which constitutes the security of such bonds. Such conduct is not cured by the fact that NOTM stock has not been "wiped out".

In the case at bar, the fiduciary parent determined the form and substance of the financial dealings between the parent and the dominated subsidiary. No independent Board of Directors of the subsidiary, NOTM, would have consented to such transactions or undertaken the financial obligations which compose the MOP Claim in suit. MOP, now in bankruptcy proceedings, seeks to insert its claim ahead of the claims of the public investors who claim through NOTM. Under such circumstances, we submit, the MOP Claim must be subordinated.

The decision of the Court below seriously limits the protection extended to public investors by the *Deep Rock* doctrine. That doctrine should not be impaired.

POINT III

Alleged insolvency of MOP and the fact that the public investors are claiming through NOTM common stock do not prevent subordination of the MOP Claim.

Nothing in the instant case prevents application of the doctrine of subordination.

(a) Parental insolvency and competing creditors

The District Court held that the Deep Rock doctrine could not be applied to the case at bar. This was on the theory that MOP was insolvent, and that innocent MOP creditors, asserting its claim, could not be held responsible for MOP's wrongdoing (R. 1111).

This contention has been rejected in both the *Deep Rock* and *Commonwealth* cases.

In the *Deep Rock* case, as the Circuit Court for the Tenth Circuit pointed out, the parent—Standard—was in Section 77B proceedings.

> *Taylor* v. *Standard Gas & Electric Co.*, 96 F. (2d) 693, 700 (C. C. A. 10th, 1938).

The advocates of the Standard claim argued before this Court that the Standard claim could, therefore, not be subordinated.* This Court disagreed.

The *Commonwealth* case arose in the reorganization proceedings of the insolvent parent. The parent's creditors vigorously argued that subordination would work to their prejudice, and was therefore inapplicable. The Seventh Circuit squarely rejected the contention, and subordinated the insolvent parent's claim.

Subordination, despite parental insolvency, has similarly been decreed by the Circuit Court of Appeals for the Sixth Circuit.

---

* Standard Brief, Supreme Court, p. 60; *id.*, p. iii, 40.

In re Kentucky Wagon Mfg. Co., 71 F. (2d) 802 (C. C. A. 6th, 1934), cert. denied sub. nom. *Laurent* v. *Stites*, 293 U. S. 612 (1934).

The contrary contention that the doctrine of subordination is inapplicable in the event of parental insolvency is based on the equitable maxim of equality between equally innocent creditors. This contention necessarily presupposes an undisputed claim where the sole basis for subordination is the parent's inequitable conduct outside the claim. Further, the contention is that the only basis for subordination disappears when the undisputed claim is asserted by blameless creditors rather than by the wrongdoing parent.

This contention cannot be raised in the case at bar because the MOP Claim is not an undisputed claim. The MOP Claim is itself, in large measure, composed of inequitable and unenforceable transactions. Such defects and infirmities remain whether wrongdoing MOP or its innocent creditors seek to assert the tainted claim.

Even if a portion of the MOP Claim should rest on undisputed advances, the *Deep Rock* case makes it clear that the Court will not attempt to separate the components of the Claim. It will not reconstruct the subsidiary's financial position, to determine what it would have been "had its fiscal affairs been conducted with an eye single to its own interests". To attempt to do so, would tend to destroy the *Deep Rock* doctrine, a salutary standard for the conduct of business by fiduciary parent corporations.

The insolvent parent's alleged claim is an asset of the insolvent to which creditors, represented by the bankruptcy trustee, succeed. With respect to this possible asset, as to others, the parent's creditors succeed to the rights of the parent and no more. It is settled that they are not in the position of an innocent purchaser for value; they remain subject to the equities under which the insolvent held the claim.

Zartman v. *First National Bank*, 216 U. S. 134 (1910);
National Bankruptcy Act, § 70;
2 Scott, *Trusts*, § 307.

(b) Public investors claiming through common stock

The fact that the public investors urging subordination are claiming through NOTM common stock, cannot prevent application of the doctrine of subordination.

The public investors in the case at bar had no voice in management. NOTM was the instrument of MOP. Indeed, MOP, prior to default, retained all voting rights on the stock pledged to secure the MOP 5¼% Secured Bonds (R. 11).

MOP clearly occupied a fiduciary position with respect to NOTM as a result of its overwhelming stock ownership and the complete domination of its affairs.

MOP further stood in a fiduciary relationship to the holders of MOP 5¼% Secured Bonds as a result of its pledge of NOTM stock to secure such bonds, and its express undertaking, in the MOP 5¼% Secured Bond Trust Indenture, not to impeach the pledge (R. 12). The Courts below so found (R. IV-19).

The Circuit Court of Appeals for the Seventh Circuit in the *Commonwealth* case, at the urging of the S.E.C., thus decreed subordination in this very situation.

There is, to be sure, a certain mechanical problem in the allocation of new securities, where a parent's claim is subordinated to public investors claiming through the subsidiary's common stock, *i.e.*, what is the extent of the claim of the common stockholder?

In the instant case, however, this mechanical problem does not arise. The public investors—pledgees of common stock—are bondholders with a clearly defined claim for principal and accrued interest on their bonds.

POINT IV

The MOP Claim may not be allowed in the absence of an independent NOTM trustee.

MOP and NOTM have one Trustee, Mr. Guy A. Thompson. This Trustee patently has conflicting loyalties. The performance of his duties as Trustee of MOP in pressing the MOP Claim inescapably clashes with his statutory duty as Trustee of NOTM to resist the Claim (Sec. 47a (8), National Bankruptcy Act). This conflict of interest has deprived NOTM of the full protection to which it is entitled by law, just as much as if it arose from opposing personal financial interests.

See 2 Scott, *Trusts*, § 170.23.

A conflict of interest on the part of the trustee was condemned by Mr. Justice Van Devanter, who as a Circuit Judge, stated:

> "* * * the trustee's action (in not contesting a claim) was accorded undue consideration, when it is considered that * * * he was represented and presumably advised by counsel who was also representing the creditor whose claim was challenged. Of course, this ought not to have been, no matter what may have been the belief of counsel respecting its propriety. The interests of the creditors were adverse to the bankrupt estate, with the protection of which the trustee was charged, and were in conflict with the interests of others who were represented by the trustee."
>
> *In re Stern*, 144 Fed. 956, 959 (C. C. A. 8th, 1906).

This principle applies no less to the instant case.

Judge Learned Hand has stated that a conflict in interest in reorganization proceedings on the part of a trustee may not be tolerated.

> *Dudley* v. *Mealey*, 147 F. (2d) 268, 272 (C. C. A. 2d, 1945), *cert. denied*, 325 U. S. 873 (1945).

The Circuit Court of Appeals in the Ninth Circuit held so as well.

Wilson v. *Continental Building & Loan Assn.*, 232 Fed. 824 (C. C. A. 9th, 1916).

But cf.

In re Chicago R. I. & P. Ry., 110 F. (2d) 395 (C. C. A. 7th, 1940).

The lack of an independent NOTM Trustee was especially harmful since the MOP Claim involved parent-subsidiary transactions, which, as we have seen, require vigorous judicial scrutiny before allowance.

Pepper v. *Litton*, 308 U. S. 295, 306 (1939).

The type of scrutiny required has been indicated by a decision of the Circuit Court of Appeals for the Fourth Circuit.

In re Central States Electric Corp., 143 F. (2d) 684 (C. C. A. 4th, 1944).

That Court insisted upon:

> "* * * an investigation of the most complete and thorough-going character, with opportunity to examine under oath those who had knowledge of the corporation's affairs * * * to the end that all the processes of discovery provided by law might be fully used" (143 F. (2d) at 686).

The failure of the NOTM Trustee to oppose the MOP Claim has not been offset by the efforts of petitioner and other public bondholders. Resources available to a trustee for the purpose of investigation obviously are superior to those at the command of scattered public investors. As the accountant for petitioner testified:

> "Mr. Thompson (the trustee) directed me to * * * Mr. Vollmer * (who) * * * stated that they would make records available, but I was not to ask any questions of any of the employees: * * * any direct questioning would have to be done in court" (R. 495).

This is far from the "opportunity to examine under oath" and the full use of "all the processes of discovery provided by law" stressed in the *Central States Electric* case.

Moreover, in the MOP reorganization, the character of MOP management and the existence of the Trustee's conflict of interest had already been the subject of formal proceedings in the District Court.

The NOTM Bondholders Committee—one of the respondents herein—and the Indenture Trustee of NOTM Bonds had previously filed petitions for the appointment of a separate Trustee for NOTM because of Mr. Thompson's conflict. Such petitions pointed out, among other things, that MOP—instead of having a claim against NOTM—was really indebted to NOTM (R. 87, 101). Hearings on the petitions are still pending (R. 109).

As we have seen, Judge Faris, then in charge of the MOP reorganization, had previously set aside the "improvident, unfair, unlawful and overreaching" Terminal Shares contracts imposed on MOP by Alleghany.

In these proceedings, furthermore, Guaranty Trust Co., which was indenture trustee of two classes of MOP securities, resigned one of its two important trusteeships because of the possibility that a conflict of interest might develop. It sought to avoid the possibility that as trustee for one group of beneficiaries it might be opposing itself as trustee for another (*Senate Committee Hearings*, 76th Cong., 3d Sess., Part 15, pp. 6671-6672).

---

* Mr. Vollmer was Executive Assistant to the Trustee (Ex. 56, R. 406).

With this background, the need for an independent trustee of NOTM and for a vigorous scrutiny of the MOP Claim were especially clear.

The common Trustee in the case at bar indicated in the District Court that he did not feel the MOP Claim was especially important; he testified that he always thought that the Claim was "washed out in the Plan, and would be washed out in any Plan" (R. 645). Accordingly, he did not announce whether or not he regarded the MOP Claim as valid until some time after the hearings had commenced in the District Court (R. 646). Previously during the hearings, the Trustee's counsel, who had served in that capacity for many years, was unable to tell the Court the Trustee's attitude on the Claim (R. 392-393).

To permit the validity of the Intercompany Claim of MOP, a fiduciary, to be established in such circumstances, is to deny to NOTM the protection to which it is entitled.

POINT V

An Adjudication on the Merits of the MOP Claim Is Necessary.

Respondents maintained in the Court below that this case may be disposed of on either of two separate grounds without an adjudication on the merits of the MOP Claim. These alleged grounds are:

(a) laches; and

(b) the MOP pledge, since redeemed, to the RFC and RCC of two NOTM notes representing a portion of, but not the entire MOP Claim.

(a) Laches

The Circuit Court opinion demonstrates that laches may not be invoked in this case.

The Circuit Court pointed out that although the District Court had expressed an opinion as to laches, the District Court

> "concluded that judicial adjudication should be made as to the debt and that the court should, and therefore it did, hear the evidence covering the whole period of management of the New Orleans by the Missouri Pacific, and it tried out the whole case and all the charges presented by Comstock on the merits." (R. IV, 21)

Similarly, the Circuit Court of Appeals gave no weight to the contention of laches and adjudicated the MOP Claim on the merits.

This was the first adjudication of the claim.

This Court has held that such a determination of the validity and priority of the Claim is indispensable for the purposes of the reorganization.

> *Ecker* v. *Western Pacific R. R.*, 318 U. S. 448, 479 (1943);
> *American United Mutual Life Ins. Co.* v. *Avon Park*, 311 U. S. 138, 145 (1940).

Without such an adjudication, allocations of new securities—a prerequisite to reorganization—cannot be made.

As the Circuit Court indicated, laches, accordingly, plays no role in the instant case.

(b) MOP's Pledge of the NOTM Notes

Respondents also seek wholly to avoid an adjudication on the merits by reliance on the legal consequences which they would draw from the one-time MOP pledge, since redeemed, of two NOTM notes representing a portion, but not the entire MOP Claim.

The District Court expressly found that only a portion of the $10,565,227 Claim was pledged to the RFC and RCC (R. 19-21). Thus, whatever the legal consequences attributed to the pledge, an adjudication on the merits

of the validity and priority of the sizable portion of the MOP Claim which was never pledged cannot be avoided. This, of itself, is a complete answer to respondents' contention.

The former pledge to the RFC and RCC does not even dispose of that portion of the Claim represented by the heretofore pledged NOTM notes. This is elementary Bills and Notes law.

(1) As between the maker (NOTM) and the payee (MOP) of these notes, it is clear that all questions with regard to the transactions surrounding their issuance remain open for determination, irrespective of transfer to a holder in due course or otherwise.

Metropolitan Elevated Ry. v. *Kneeland,* 120 N. Y. 134, 24 N. E. 381 (1890).
Gates v. *Ritchie,* 162 Ark. 484, 258 S. W. 397 (1924).

(2) Subsequent to the decision of the District Court in this case, the notes were reacquired by the payee, MOP, through its trustee, which is again the holder (R. 1155). It is settled that a payee reacquiring an instrument—even from a holder in due course—is subject to all the equities and defenses of the maker.

Uniform Negotiable Instruments Law, Sec. 58.*

(3) The RFC and RCC are no longer in the case. The District Court's findings with respect to their position have become moot.

At present no MOP creditor has succeeded to any of their rights. The District Court order, authorizing payment of the RFC and RCC, only subrogated MOP creditors to the rights of the RFC and RCC "to the extent of their respective interests, if any, in the cash used in the

* The Uniform Negotiable Instruments Law is in force in both Missouri and Ohio.

purchase of" the RFC and RCC claims (R. 1157, 1165). The District Court to this date has not determined whether respondents or any other MOP creditors had an interest in such cash. Until such determination is made, no creditor can be said to have any interest in the NOTM notes.

Accordingly, it is understandable why the Circuit Court did not regard the legal consequences of the MOP pledge as of sufficient importance to merit discussion.

CONCLUSION

It is respectfully submitted that the order and judgment of the Circuit Court of Appeals for the Eighth Circuit be reversed and the cause be remanded with directions that the MOP Claim be disallowed or subordinated to the claims of the holders of MOP 5¼% Secured Serial Gold Bonds.

Respectfully submitted,

WILLIAM H. BIGGS,
Attorney for Petitioner,
Security Building,
St. Louis 2, Missouri.

PHILLIP I. BLUMBERG,
of Counsel.